BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MARC SPITZER, Chairman
JIM IRVIN
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
MIKE GLEASON

In the matter of: Philip William Merrill 3788 N. 156th Drive Goodyear, Arizona 85338, Respondent.	DOCKET NO. S-03450A-02-0000 **POST HEARING MEMORANDUM BY SECURITIES DIVISION**

The Securities Division ("Division") of the Arizona Corporation Commission ("Commission") herby submits the following Post Hearing Memorandum in the above-captioned matter.

STANDARD OF PROOF

In administrative adjudications brought by the Commission, the standard of proof for alleged violations of the Securities Act of Arizona ("Securities Act") A.R.S. § 44-1801 *et seq.*, is "preponderance of the evidence." This standard has been uniformly applied in administrative proceedings in this and other jurisdictions. See *Steadman v. Securities and Exchange Commission,* 450 U.S. 91, 101 S.Ct. 999, 67 L.Ed. 2d 69 (1981) (Securities and Exchange Commission properly applied the 'preponderance of the evidence' standard in an administrative adjudication of alleged antifraud violations of the federal securities laws). See also, *Geer v. Ordway,* 156 Ariz. 588, 589, 754 P.2d 315, 316 (App.1987) ("preponderance of the evidence" was applicable standard in administrative adjudication of state motor vehicle operator licensing law). Therefore, it follows that the standard of "preponderance of the evidence" is equally applicable in this administrative proceeding.

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I.

THE SECURITIES ACT OF ARIZONA

A. Purpose of the Securities Act

The basic purpose of the Securities Act is the prevention of fraud upon consumers of securities. *People ex rel. Babbitt v. Green Acres Trust*, 127 Ariz. 160, 166, 618 P.2d 1086, 1092 (App. 1980), citing *Jackson v. Robertson,* 90 Ariz. 405, 368 P.2d 645 (1962). The Securities Act is designed to be prophylactic where possible and remedial when necessary. *Id* at 166. The Arizona Supreme Court has declared that the regulation of securities is designed to protect the public from fraud and deceit since most of the public lack the knowledge and sophistication of those persons who trade regularly in the stock market. *State v. Baumann*, 125 Ariz. 404, 411, 610 P.2d 38 (1980).

B. Interpretation of the Securities Act

Even though Arizona often looks for guidance to federal securities cases and interpretations of federal statutes that are the same or similar to Arizona statutes, the Commission has opined that Arizona securities laws should be more broadly construed than federal securities laws. *In the matter of the Offering of Securities by: Woodington Group, Inc. et al., A*rizona Corporation Commission Decision No. 58113 (December 10, 1992), p. 11. In this same Decision, the Commission held that the Securities Act must be broadly interpreted as a remedial measure to ensure protection of Arizona investors. *Id.* at 11. These interpretations of the Securities Act are consistent with the legislative intent of the Securities Act which is: ". . . This Act shall not be given a narrow or restricted interpretation or construction, but shall be liberally construed as a remedial measure in order not to defeat the purpose thereof." See, *Laws 1951, Ch. 18, § 20.*

II.

FRAUD IN CONNECTION WITH THE OFFER OR SALE OF SECURITIES

In the Notice of Opportunity for Hearing filed by the Division, the only statute the Division alleged Respondent violated in the Securities Act was the anti-fraud statute, A.R.S. § 44-1991(A).

More specifically, the Division alleged that Respondent violated paragraphs (2) and (3) of subsection (A) of the anti-fraud statute.

Evidence adduced at the hearing showed that Respondent violated the anti-fraud statute by conducting unsuitable transactions in customers' accounts, by advising customers to maintain an over-concentration of certain securities in their portfolios, by failing to disclose risks involved in purchasing some securities, by failing to disclose the fact that sales charges would be assessed on the sale of certain securities and the approximate amount of those sales charges, by conducting securities transactions in customers' accounts without their authorization and by other actions.

Under A.R.S. § 44-1991(A), it is a fraudulent practice and unlawful for a person, in connection with a transaction or transactions within or from this state involving an offer to sell or buy securities, or a sale or purchase of securities, directly or indirectly to do any either of the following:

(2) Make any untrue statement of material fact, or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading;

(3) Engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit.

A.R.S. § 44-1991(A)(2) and (3). Securities fraud may be proven under either one of these paragraphs. *Hernandez v. Superior Court,* 179 Ariz. 515, 521, 880 P.2d 735 (App.1994).

Materiality is an element of A.R.S. § 44-1991(A)(2). Arizona has adopted an objective test for determining materiality. The test is met by showing a "substantial likelihood that, under all the circumstances, the misstated or 'omitted fact would have assumed actual significance in the deliberations' of a reasonable buyer." *Trimble v. American Sav. Life Ins. Co.,* 152 Ariz. 548, 553, 733 P.2d 1131, 1136 (App.1986); citing *Rose v. Dobras,* 128 Ariz. 209, 214, 624 P.2d 887, 892 (App.1981); quoting *T.S.C. Industries, Inc. v. Northway, Inc.,* 426 U.S. 438, 449, 96 S.Ct. 2126, 2132, 48 L.Ed.2d 767 (1976).

It is not necessary for the Division to show that Respondent intentionally misstated or omitted any material facts in order for A.R.S. § 44-1991(A)(2) or (3) to apply. *Rose,* 128 Ariz. at 214. This is because scienter is not an element of this violation of the anti-fraud statute. *Id.* at 214. In Arizona, even innocent misrepresentations in the sale of securities can be a violation of A.R.S. § 44-1991(A). *Rosier v. First Financial Capital Corp.,* 181 Ariz. 218, 222, 889 P.2d 11 (1995).

Some violators of A.R.S. § 44-1991(A) have argued that because of a lack of due diligence on the part of investors, they should be absolved from any violation of the anti-fraud statute. The anti-fraud statute does not require investors to act with due diligence, nor is their any judicial authority in Arizona for such a requirement. *Trimble v. American Sav. Life Ins. Co.,* 152 Ariz. 548, 553, 733 P.2d 1131, 1136 (App.1986). Those persons who sell securities have an affirmative duty not to mislead investors in any way. *Id.* at 553.

Respondent's counsel at the hearing raised the defenses of ratification and waiver. These defenses are not valid defenses to violations of A.R.S. § 44-1991(A). This position is supported by the cases and legal propositions cited above. This is especially true since this is an administrative proceeding by a regulatory agency. The Division need only show a material omission or misrepresentation in order to establish a violation of A.R.S. § 44-1991(A).

A. Respondent Failed to Adequately Disclose Risks to Clients DuChene and Brotherson

During the hearing, both former customers of Respondent, Beatrice DuChene ("Duchene") and Viola Brotherson ("Brotherson"), testified that they relied on Respondent because neither one of them had much experience or knowledge concerning investing in the stock market. Ms. DuChene trusted Respondent so much that she readily signed documents brought to her by Respondent without asking questions and without any explanation of what she was signing. Hearing Transcript ("H.T."), page 83, lines 12 and 13; page 213, lines 19-23; *Hearing Exhibit ("Exh.") 50*, page ACC01652. Ms. Brotherson testified that she trusted Respondent simply

because he was her adviser. *H.T.*, page 550, lines 13-17; page 571, lines 8-10. Ms. DuChene and Ms. Brotherson depended entirely on Respondent for recommendations as to what investments to buy and sell. *H.T.*, page 240, lines 12-14 (DuChene); page 540, lines 3-9 and page 571, lines 1-14 (Brotherson). Ms. DuChene never even did so much as to conduct research into any security or recommend to Respondent what she thought she should buy or sell. *H.T.*, page 240, line 2-11. The reliance Ms. DuChene and Ms. Brotherson possessed in Respondent as their financial adviser, inherently included their belief that Respondent would explain all material risks to them and only recommend suitable investment for their securities portfolios. Yet, despite this reliance on Respondent, he failed to discuss and explain the material risks intrinsic in each product sold along with the material risks disclosed in the prospectus for each product sold.

Ms. DuChene's testimony at the hearing made it clear that she was a risk averse investor and that Respondent had not disclosed any risks to her concerning her investments. Ms. DuChene asserted that Respondent never even raised the issue of risk when discussing the purchase or sell of securities. *H.T.*, page 36, lines 6-25; page 37, lines 1-3. Ms. DuChene consistently stated that she did not want to accept risk, even if it meant more income to her which is what she wanted. *H.T.*, page 36, lines 6-25; page 37, lines 1-3; page 141, lines 18-25; page 142, lines 1-6; page 143, lines 19-25; page 144, lines 1-25. When asked about risks disclosed to her regarding the Dean Witter High Income[1] ("High Income/Yield") fund which she had owned, she replied that Respondent had not told her about any risk related to this fund. *H.T.*, page 219, lines 17-25; page 220, lines 1-7. Likewise, she claimed that Respondent had not told her about any risks in the Dean Witter Dividend Growth Fund which she had held in her securities portfolio. *H.T.*, page 220, lines 8-18.

Ms. Brotherson's testimony regarding whether or not she was risk averse was more incoherent and confusing than that of Ms. DuChene. She stated several times that she did not want to accept much risk and that she wanted conservative investments that produced income for her

[1] This fund later changed its name to Morgan Stanley Dean Witter High Yield. To avoid confusion this fund will be referred to as the High Income/Yield fund.

and preserved her investment principal. *H.T.*, page 503, lines 22-25; page 504, lines 1-2; page 550, lines 8-12; page 554, lines 15-25; page 555, lines 1-2. Even on cross-examination, she said she wanted conservative investments without too much risk. *H.T.*, page 578, lines 10-18. She understood that there was always at least some risk. *H.T.*, page 578, lines 19-21. However, she also stated that she was willing to invest in speculative investments and take more risks. *H.T.*, page 500, lines 11-14; page 606, lines 22-25; page 607, lines 1-4. When asked what investments she had invested in that were speculative, she had no idea nor did she have any knowledge of anything regarding these possibly speculative securities. *H.T.*, page 502, lines 2-9.

Ms. Brotherson unequivocally denied that Respondent ever discussed with her the relationship between income and risk, which is, the more income received from an investment the higher the risk an investor must take. *H.T.*, page 606, lines 3-17. Even more critical than this failure by Respondent to discuss this general principal, was Respondent's failure to disclose any risks in some of the mutual funds he invested Ms. Brotherson's money into, such as the High Income/Yield fund and the Morgan Stanley Dean Witter Health Sciences ("Health Sciences") fund. *H.T.*, page 524, lines 19-25; page 525, lines 1-4.

Respondent should have at least raised with Ms. DuChene and Ms. Brotherson some of the material risks disclosed in the prospectuses for the High Income/Yield fund, the Health Sciences fund and the Morgan Stanley Dean Witter Information ("Information") fund. This way, these customers would have at least been aware of the risks in these investments.

The High Income/Yield fund was a junk bond fund as disclosed in its prospectus. *Exh. 31A*, page 4. The prospectus for the fund disclosed that the bonds that constitute the fund are subject to greater risks than higher-rated securities and are considered to be speculative as to payment of interest and return of principal and are not intended for short-term investing. *Exh. 31A*, page 4. Investors in this fund were advised to consider their ability to assume the risks involved in the fund. *Exh. 31A*, page 4 and 6. This hardly sounds like the type of risks two retired elderly

ladies living on social security and income from their investments should be exposed to. *H.T.*, page 34, lines 34 and 35; page 35, lines 1-14; page 505, line 25; page 506, lines 1-6

The Health Sciences fund, though not a junk bond fund, did have some material risks that should have been disclosed to Ms. Brotherson. This mutual fund as the name implies concentrates its investments in the health sciences industry. *Exh. 32A*, page 5. Due to this concentration, the value of the shares in this fund can be more volatile than mutual funds that do not similarly concentrate their investments. *Exh. 32A*, page 5. Because the health sciences industry is subject to substantial regulation, it could be adversely affected by changes in governmental regulations. *Exh. 32A*, page 5. The investment objective of this fund was to select securities with the potential to rise in price rather than pay out income. *Exh. 32A*, page 4. Ms. Brotherson, wanted income from her investments not appreciation in value. *H.T.*, page 570, lines 18-25.

The Information fund, a fund both ladies had owned, like the Health Sciences fund, is an industry concentrated fund that concentrates its investments in the communications and information industry. *Exh. 33* (prospectus as filed with the SEC on May 25, 1999), page 5. Also, like the Health Sciences fund, the value of shares in the Information fund can be more volatile than shares in a fund that does not similarly concentrate its investments in one industry. *Exh. 33*, page 5. According to the prospectus for this fund, governmental regulatory approvals and restrictions may materially affect this industry. *Exh. 33,* page 5.

The Commission has held in past decisions that the failure, by a person selling securities, to adequately discuss risks accompanying an investment is the omission of material facts and a violation of A.R.S. § 44-1991(A)(2). See *In the matter of the offering of securities by: Buchanan & Co., Inc.,* et al., Decision No. 57365 (May 2, 1991); *In the matter of the offering of securities by: Boucher, Oehmke & Company, et al.,* Decision No. 57979 (August 7, 1992).

In the case of *Buchanan & Co., et al.,* the Commission found that one of the Respondents omitted an adequate discussion of the risks of speculative bonds with at least two of his customers who purchased these bonds. *Buchanan & Co., Inc.,* et al., Decision No. 57365, page 64, lines 11-

15; page 70, lines 3-7. These omissions along with the Respondent's failure to diversify investments of some of his customers, was enough for the Commission to find he had made material omissions and misstatements. *Buchanan & Co., Inc.,* et al., Decision No. 57365, page 206, lines 15-28.

In the case of *Boucher, Oehmke & Company, et al.,* the Commission agreed that two of the Respondents had omitted material facts regarding the investments during discussions with customers. One Respondent's failure to adequately explain the investment and the accompanying risks to an investor was deemed by the Commission to be an omission of material facts. *Boucher, Oehmke & Company, et al.,* Decision No. 57979, page 12, lines 10-13. Furthermore, these same omissions were held to be violations of A.R.S. § 44-1991(A)(3). *Id.* at page 12, lines 14-28 and page 13, lines 7-8. With respect to a different Respondent in this same case, the Commission's Opinion was that the Respondent as a salesman of securities had an obligation to discuss the risks of an investment with his customers and to ensure that the customers understood the investment and the corresponding risks. *Boucher, Oehmke & Company, et al.,* Decision No. 57979, page 21, lines 6-28. Because this salesperson failed to met what the Commission thought were his obligations, the Commission opined that he had violated paragraphs (2) and (3) of the securities anti-fraud statute. *Id.* at page 21, lines 6-28; page 22, lines 1-9. One of the reasons the Commission felt that this salesperson was obligated to discuss risks and make certain his customers understood the investment and the accompanying risks was because he was dealing with retired individuals who had no significant investment experience and who relied heavily upon him. *Id.* at page 21, lines 26-28. This is the very same relationship Respondent in the above captioned case had with Ms. DuChene and Ms. Brotherson, whom were both elderly retired ladies with insignificant experience investing and who both relied entirely on Respondent for investment advice.

Besides failing to disclose to Ms. Brotherson corresponding risks with her investments, Respondent failed to advise Ms. Brotherson of the contingent deferred sales charges she would

incur upon the sale of mutual funds initially held in her securities portfolio. Ms. Brotherson unwaveringly testified at the hearing that she was not informed of any sales charges for the sale of mutual funds until she received statements in the mail from the mutual fund companies showing the charges she had incurred. *H.T.*, page 523, lines 14-20; page 526, lines 4-15; page 532, lines 12-25; page 533, lines 1-25; page 534, lines 1-22; page 574, lines 9-21; page 575, lines 10-25; page 576, lines 1-11; *Exhs. S-24*, pages ACC02131 and ACC02127.

B. Respondent Conducted Unsuitable Transactions and Failed to Disclose them to Ms. DuChene and Ms. Brotherson.

In the Notice of Opportunity for Hearing, the Division alleged that Respondent conducted unsuitable transactions with respect to two of the five customers listed in the Notice. Those two customers are Ms. DuChene and Ms. Brotherson. The Division established at the hearing through testimony of these two former customers of Respondent, new account forms, rules and other information pertaining to suitability, an expert witness and other evidence, that Respondent had conducted unsuitable transactions.

In Arizona, a registered representative has an obligation to only recommend suitable investments to his customers. A salesperson violates this obligation when he does not have reasonable grounds to believe the recommendation is suitable for the customer given the customer's investment objectives, financial situation and needs, and other information known by the salesperson. *A.A.C. Rule R14-4-130(A)(4)*. The determination of suitability is determined on the basis of information furnished by the customer after any necessary inquiry by the salesperson under the circumstances. *Id.* The National Association of Securities Dealers ("NASD") has a rule for conducting transactions with customers that is worded very similarly to the Arizona rule for suitability. See, *Exh. S-55*, Section 2310(a) and (b) Recommendations to Customers (Suitability). This NASD rule was addressed and introduced as evidence at the hearing. *H.T.*, page 1912, lines 7-25, page 1913, lines 8-12. In the past, the Commission has recognized this NASD rule as an industry standard and one that can provide guidance even though it has not been adopted by the

Commission. *In the matter of the offering of securities by: Boucher, Oehmke & Company, et al.*, Decision No. 57979 (August 7, 1992), page 13, lines 15-28 and page 14, lines 1-13.[2] Both of these rules regarding suitability applied to Respondent during his course of dealings with Ms. DuChene and Ms. Brotherson. The criteria and policies Respondent's securities dealer considered to be important when determining suitability were also addressed and introduced into evidence at the hearing in the form of relevant pages from the Compliance Guide for Respondent. See, *Exh. S-53*, pages ACC00590, ACC00591, ACC00592, ACC00680 and ACC00681.

Testimony at the hearing by Ms. DuChene and Ms. Brotherson was unambiguous about their investment objective, which was to receive more income. *H.T.*, page 34, lines 24 and 25; page 35, lines 1-7; page 73, lines 9-13 (Ms. DuChene); *H.T.*, page 554, lines 2-11; page 562, lines 4-22; page 563, lines 14-17 (Ms. Brotherson). According to Ms. DuChene, she was never interested in aggressive income or speculation as her investment goals. *H.T.*, page 73, lines 14-25; page 74, lines 1-10.

The new account forms for Ms. DuChene were not helpful because the most relevant one was completed in November 1990, long before Respondent became her financial adviser and the last one was completed in October 1998, one to two months before she transferred her accounts away from Respondent. *Exh. S-2*. The investment objectives shown in the October 1998 new account form are clearly erroneous because aggressive income is shown as the second priority for Ms. DuChene. *Exh. S-2*. Neither one of these account forms contained the signature of Ms. DuChene further proving that she had no idea what the listed investment objectives on these forms were. *Exh. S-2*. Both of these new account forms show her as single and retired which was correct. *Exh. S-2*.

Similarly, the only new account form showing investment objectives for Ms. Brotherson was dated in July 1990. *Exh. S-19*. This is even though Respondent became her financial adviser

[2] Note, the Boucher, Oehmke & Company, et al., case did not refer to the Arizona rule for suitability, A.A.C. Rule R14-4-130(A)(4), because that rule did not become effective until November 4, 1992, after the Opinion and Order on the Boucher, Oehmke & Company, et al., case had been signed by the Commission.

in 1996. *Exh. S-19*, page ACC04632. The new account form for Ms. Brotherson shows that she is single, retired and has an investment objective of only aggressive income. *Exh. S-19.* In the sections concerning financial information, someone wrote the following which is difficult to make out, "client doesn't want to answer." This crucial financial information regarding Ms. Brotherson such as income, net worth, liquid assets and tax bracket were never updated by Respondent. *Exh. S-19.* A summary, provided by Morgan Stanley, of the investment objectives and financial information of Ms. DuChene and Ms. Brotherson was also introduced into evidence at the hearing. *Exh. S-19A*; *H.T.*, page 830, lines 1-24.

Although, Ms. DuChene's securities portfolio did contain many investments that were suitable for her given the relevant factors, there were also many securities the Respondent put here into that were not suitable at all for her, especially since she was so risk averse. Mr. Donovan, the Division's expert at the hearing, created a table titled "Suitability Review." *Exh. S-5.* This table listed every trade in Ms. DuChene's securities accounts with the amount of fees (including deferred contingent sales charge) and/or loss for each trade Mr. Donovan considered unsuitable. *Exh. S-5.* The trades Mr. Donovan considered unsuitable were designated by a "U" on the same line as the transaction in about the middle of each page. *Exh. S-5.* Mr. Donovan also gave testimony at the hearing as to why he considered some investments unsuitable for Ms. DuChene.

One of the big contentions at the hearing was over whether or not Ms. DuChene's investment in the High Income/Yield (later renamed "High Yield") mutual fund was suitable for her given relevant factors and because of the percentage of her portfolio through much of 1997 and part of 1998 that consisted of this fund.

Even though Ms. DuChene wanted more income as she testified at the hearing, the High Income fund did not meet her investment objectives. As proven above by citations to the hearing transcript, Ms. DuChene was not tolerant of risk at all, her only source of income besides social security was from her investments, she could not emotionally withstand a substantial loss of her principal, and her investment objectives on her new account form dated in November 1990 was

capital appreciation and income (not aggressive income). *H.T.*, page 34, lines 34 and 35; page 35, lines 1-14. She specifically testified at the hearing that had she known the attendant risks in the High Income/Yield fund, she would not have allowed her money to be invested in it. *H.T.*, page 220, lines 3-7.

A review of the account statements for 1997 for the three accounts of Ms. DuChene reveals that she had any where from twenty-one to thirty percent of her entire securities portfolio in the High Income/Yield fund between February 1997 and December 1997. See attached *Exhibit A*. An examination of her account statements from February through November 1998 shows DuChene's entire securities portfolio was concentrated in the High Income fund anywhere from twenty-eight to thirty-four percent. See attached *Exhibit A*. These percentages do not include in their calculation the value of Ms. DuChene's variable annuities.

Respondent's counsel vehemently argued that the annuities should be included in calculating the percentage exposure Ms. DuChene had in the High Income/Yield fund. The variable annuities in Ms. DuChene's accounts were very distinct from the other securities in her accounts and should not be included in determining concentration of securities in her portfolio. Variable annuities are a mixture of insurance and securities investments, generally mutual funds. A variable annuity is held by an insurance company not a securities dealer. Variable annuities are subject to surrender charges for the first several years, generally seven to nine years depending on the terms of the annuity. The surrender charge often starts at seven to nine percent and declines each year, again depending on the terms of the annuity. Most annuity contracts allow the owner to withdraw from ten to fifteen percent each year without incurring the hefty surrender charge assuming the surrender charge period still applies. If Ms. DuChene had needed to withdraw a considerable amount of money from one of her annuities while Respondent was her financial adviser, she would have likely paid a hefty surrender charge, much more than any sales charges she would have paid if she had sold some of the stocks or mutual funds in her portfolio.

Even if annuities are considered in the calculation of concentration of the High Income/Yield fund in Ms. DuChene's securities portfolio, she was still over-concentrated in this one fund. By Respondent's own calculations, the High Income fund constituted any where from six to eighteen percent of her entire portfolio from January 1996 to October 1998. See, *Exh. R-2*, 1096.

The very documents Respondent introduced into evidence to support his position, actually eroded his argument that this high concentration of the High Income/Yield fund was suitable for Ms. DuChene. *Exh. R-1*, page 1001-1003 and 1006. In the Business Week article titled "Junk Bonds Are Looking a Lot Less Junky" the article reads as follows: "Still, these bonds are best used in moderation: Financial advisers suggest **allocating no more than 3% to 5% to a high-yield bond fund**" (emphasis added). *Exh., R-1*, page 1001. Another article provided by Respondent at the hearing emphasizes one of the overwhelming risks of junk bond funds, the potential for bigger losses as compared to funds consisting of higher grade corporate bonds. *Exh. R-1*, page 1006. As Respondent's Exhibit R-1 is reviewed, it should be remembered that both Ms. DuChene and Ms. Brotherson held the High Income fund until the fund name changed to Dean Witter High Yield securities in November 1997 after merging with that fund. The percentage concentration of the High Income/Yield fund in Ms. DuChene's account was too high and simply did not meet her investment objectives, especially considering her aversion to risk.

As mentioned above, the Division's expert, Mr. Donovan, opined that other securities besides the High Income/Yield fund were unsuitable for Ms. DuChene. The Health Sciences fund was considered unsuitable for Ms. DuChene because, among other reasons, it is a narrow sector fund which adds more risks. *H.T.*, page 734, lines 1-25. The Morgan Stanley Dean Witter Competitive Edge fund was judged to be unsuitable for Ms. DuChene because it invested in stocks that were not consistent with her investment objectives. *H.T.*, page 758, lines 16-25. The other transactions recommended and conducted by Respondent that Mr. Donovan opined were unsuitable were all investments in stock. These equity investments were all deemed by Mr.

Donovan to be above average risk and therefore incompatible with Ms. DuChene's investment objectives. *H.T.*, page 763, lines 13-18; page 764, lines 3-15; page 835, lines 18-25; page 836, lines 1-25; page 837, lines 1-2. These companies were in the computer, computer software and hardware, semi-conductor and oil drilling industries, all risky sectors for investments. *Id.* Companies, such as Electroglas, Cybercash, Nabors Industries and Smart Modular, were smaller capitalized companies which entailed more of a risk in investing in them.

Recommendations and transactions conducted in Ms. Brotherson's account by Respondent were not only unsuitable due to the very innate risks of the securities purchased, but also due to the extreme over-concentration of a single mutual fund at a time in her account. *Exh. S-21.* From January 1998 through July 2000, the High Income/Yield fund constituted a range of 72% to as high as 88% of Ms. Brotherson's securities portfolio. *Exhs. S-21; S-24; S-25 and S-26.* Ms. Brotherson did not own any annuities so the issue of whether or not her annuities should be included in calculating the percentage concentration of one security is irrelevant. From August through November of 2000, the Information fund consisted of 73% to 81% of her portfolio. *Exhs. S-21 and S-26.* In December 2000, the Information fund was exchanged for the Health Sciences fund. *Exhs. S-21 and S-26, page ACC02647.* From December 2000 until April 2001, when Respondent was terminated from association with Morgan Stanley Dean Witter, the Health Sciences fund constituted any where from 72% to 76% of her entire securities portfolio. *Exhs. S-21; S-26; S-27 and S-28.* From January 1998 until April 2001, the only securities in Ms. Brotherson's account besides shares in one mutual fund at a time, were 300 shares of preferred stock, all in the same company. *Exhs. S-24; S-25; S-26; and S-27.*

The investment objective of the Information and the Health Sciences funds was capital appreciation, not income. *Exhs. S-32A, page 4; S-33 page 4; and S-33A, page 6.* In fact, the prospectus for the Health Sciences fund says the objective of the fund is to select ". . . securities with the potential to rise in price rather than pay out income." *Exh. 32A, page 4.* As proven above

be references to the record, Ms. Brotherson's investment objective was income not capital appreciation as was sought by these two funds.

Although the investment objective listed on Ms. Brotherson's new account form was aggressive income and she stated at the hearing that she might be willing to invest in speculative securities, even though she testified other times that she was a conservative investor and did not want to lose her principal, the high concentration of the High Income/Yield, Information and Health Sciences funds in her portfolio were unsuitable for her because they over exposed her to the risks of being predominantly invested in only one fund at a time. *Exh. S-19.*

The new account form introduced at the hearing was dated in July 1990. *Exh. S-19.* This was almost six years before Respondent became her financial adviser and apparently, Respondent never even tried to update crucial information requested on this form. *Exh. S-19, page ACC04632.*

Respondent knew that Ms. Brotherson was retired. After all, she was 84 years old at the time of the hearing. *H.T.,* page 484, lines 16-17. As she testified at the hearing, the majority of her assets were invested in her securities portfolio, not in real estate or cars. *H.T.,* page 505, lines 15-24. As mentioned above she lived off the income from social security and her investment portfolio. *H.T.,* page 505, line 25 and page 506, lines 1-25. She did have an investment in the Baptist Foundation that provided her with income until the company went bankrupt. *H.T.,* page 506, lines 21-25 and page 507, lines 1-8.

Preserving her investment principal was crucial to Ms. Brotherson as she told Respondent when he first became her financial adviser. *H.T.,* page 554, lines 15-25; page 555, lines 1-2 and page 578, lines 10-18. As an elderly retiree, she could not afford to lose this source of income. Respondent knew or at least should have known these very important financial factors concerning Ms. Brotherson.

In the past, the Commission has found that securities salespersons that failed to adequately diversify a customer's portfolio or recommended to a customer purchases in a security that constituted a large percentage of the customer's securities portfolio violated the Arizona securities

anti-fraud statute. See *In the matter of the offering of securities by: Buchanan & Co., Inc.,* et al., Decision No. 57365 (May 2, 1991); *In the matter of the offering of securities by: Boucher, Oehmke & Company, et al.,* Decision No. 57979 (August 7, 1992). In the case of *Buchanan & Co., Inc.,* et al., the Commission held that some of the risky and speculative bonds in certain customers' securities portfolios may have been suitable at the time if the salesperson had diversified the customers' securities portfolios into other investments. *Buchanan & Co., Inc.,* et al., pages 67, lines 16-27 and 70, lines 3-7. Due to the fact that the salesperson omitted material facts concerning the investment while speaking with investors and failed to diversify certain customers' securities portfolios, the Commission judged a salesperson to have made material misrepresentations and omissions to investors in violation of A.R.S. § 44-1991(A). *Buchanan & Co., Inc.,* et al., page 206, lines 15-25.

In the other Commission case mentioned above, the Commission found that two salesmen had conducted unsuitable transactions with some of their customers by recommending purchases of interests in partnerships that constituted large percentages of the investors' portfolios. *Boucher, Oehmke & Company, et al.,* page 7, lines 14-26; page 9,lines 4-15; page10, lines 3-28; page 11, lines 1-5; page 12, lines 19-24; page 22, lines 13-18. The Commission held that even if the recommendation of these securities was suitable for some investors, the large concentration of these securities in the investors' portfolios made the recommendation unsuitable. *Id.* at page 12, lines 19-24 and page 22, lines 13-18. The Commission also held that these unsuitable recommendations by two salespersons was the practice or course of business which operated as a fraud or deceit upon their customers in violation of A.R.S. § 44-1991(A)(3). *Id.* at page 12, lines 14-24 and page 22, lines 4-18.

Neither Respondent nor his counsel can argue meritoriously that the severe over-concentration in the High Income/Yield, Information and Health Sciences funds in Ms. Brotherson's account were suitable for her, particularly with the risks corresponding with these funds, especially the High Income/Yield fund, the mismatch between Ms. Brotherson's investment

goal of income and the investment objective of the Information and Health Sciences funds of capital appreciation, her financial status and other relevant factors. Respondent should be required to pay restitution to Ms. Brotherson for sales charges and losses resulting from his unsuitable recommendations and sales to her.

C. Respondent Failed to Disclose Unauthorized Transactions in Customers' Accounts.

In the Notice of Opportunity for Hearing, the Division alleged that all five of the former customers named in the Notice claimed that Respondent conducted at least one unauthorized trade in one or more of their accounts. The testimonies of Janet Mayfield, Lori Mayfield and Sylvia Hays, unequivocally established that Respondent had in fact conducted unauthorized trades in their accounts. Prior to the hearing, Respondent admitted in writing to the NASD that he had conducted unauthorized trades in the accounts of Lori Mayfield while she was on vacation in India. *Exh. 50,* pages ACC02832, ACC02829, ACC02830, ACC01840, ACC01920. The alleged unauthorized trades by Respondent will be summarized as best as possible below.

1. Unauthorized Trades in Accounts of Beatrice DuChene.

When Ms. DuChene testified she was sure about one thing without any doubt and that was she had not authorized Respondent to sell her General Electric stock in December 1997. *H.T.,* page 43, lines 6-25; page 44, lines 1-19. According to Ms. DuChene, the first unauthorized transaction she became aware of was the sale of her General Electric stock. *H.T.,* page 43, lines 6-19. Ms. DuChene asserted that she had never given permission to Respondent to make any trades in her account with out her authorization. *H.T.,* page 43, lines 6-13, page 60, line 25, page 61, lines 1-7. She also testified that she reviewed transactions in her accounts in 1998 with her daughter and her daughter created a table listing the transactions Ms. DuChene alleged were unauthorized with short explanations why some of the trades were unsuitable. *Exh. 3A,* pages ACC00236, ACC00237and ACC00238; H.T., page 54, lines 10-24; page 56, lines 24-25; page 57, lines 1-6.

2. Unauthorized Trades in Account of Viola Brotherson.

Although allegations of unauthorized trades arose against Respondent before the hearing, they were not substantiated during Ms. Brotherson's testimony.

3. Unauthorized Trades in Accounts of Janet Mayfield.

Janet Mayfield, the mother of Lori Mayfield, provided testimony at the hearing concerning unauthorized trades Respondent had conducted in her accounts. The trades Janet Mayfield alleged were unauthorized were as follows: Triquint Semiconductor, Inc., (11/16/00); Inktomi CRP, (11/17/00); VK Biotech Pharmaceutical Stock (12/18/00); and Home Depot, Inc. (1/8/01). *H.T.*, page 1341, lines 7-24; page 1344, lines 23-25; page 1345, lines 1-9; page 1347, lines 2-20; page 1348, lines 9-21; *Exhs. S-37; S-38 and S-39.*

4. Unauthorized Trades in Accounts of Lori Mayfield.

Lori Mayfield testified that she was away from home on a vacation to India from December 12, 2000 through January 11, 2001, Respondent conducted unauthorized trades in two of her accounts. *Exhs. S-44 and S-45.* The unauthorized trades per Lori's testimony at the hearing were the following: Cree Research, Inc., (12/26/00); General Electric (12/19/00); Morgan Stanley Dean Witter Health Sciences fund (12/14/00); Van Kampen Emerging Growth B (12/14/00). *H.T.*, page 1252, lines 11-17; page 1253, lines 19-25; page 1254, lines 1-25; page 1255, lines 1-22; page 1256, lines 7-10; page 1258, lines 17-25; page 1259, lines 1-5; page 1267, lines 1-4; page 1318, lines 8-13; *Exh. S-41.* Besides these unauthorized trades, Respondent made one other unauthorized trade after Lori returned from her vacation to India. This trade was in Triquint Semiconductor, Inc., on February 5, 2001. *H.T.*, page 1266, lines 9-23; page 1306, lines 22-24; *Exh. S-43.* Besides admitting in writing to the NASD that he had conducted unauthorized transactions in two accounts of Lori Mayfield, Respondent also admitted at the hearing to conducting unauthorized trades in her accounts.

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5. Unauthorized Trade in Account of Sylva Hays.

Before and during the hearing Ms. Hays only complained about one unauthorized trade made by Respondent in her account. This unauthorized transaction alleged by Ms. Hays was conducted by Respondent in Ms. Hay's account in September 2000 and was the exchange of shares in the Morgan Stanley Dean Witter Dividend Growth fund for shares in the Information fund. *H.T.*, page 1475, line 25; page 1476, lines 1-25; page 1477, lines 1-9; page 1479, lines 3-10; *Exh. S-47,* ACC04248.

III.

RESTITUTION

A. Respondent Should Be Required to Pay Restitution to Ms. DuChene, Ms. Brotherson and Ms. Hays.

At the hearing, the Division did not seek damages for Lori and Janet Mayfield. This was because they had both settled their claims with Morgan Stanley before the hearing began. The Division did seek damages for Respondent's fraudulent conduct in reference to Ms. DuChene, Ms. Brotherson and Ms. Hays.

Damages are not always easy to determine in cases such as this that involves unsuitable and unauthorized transactions. The Ninth Circuit Court of Appeals wrote in an opinion involving churning by a stock broker that where exact damages are precluded by the broker's wrongful acts the damages award need only be a fair approximation of actual damages. *Hatrock v. Edward D. Jones & Co.,* 750 F.2d 767, 774 (9thCir.1984). Another court has said in reference to losses that "It is difficult to characterize the remedy due a fraud victim as a 'windfall,' even if it exceeds total out-of-pocket loss." *Merchant v. Oppenheimer & Co., Inc.,* 568 F.Supp. 639, 644 (D.Va. 1983) (affirmed in part, reversed in part on issue of attorney's fees and costs by *Dixon v. Oppenheimer and Co., Inc.,* 739 F.2d 165 (4thCir. 1984)).

At the hearing, Respondent's counsel emphasized how Ms. DuChene's securities portfolio had appreciated in value during the time period Respondent was her financial adviser. Counsel for

Respondent at least insinuated that since the portfolio appreciated in value, any losses should be offset by the gains in the portfolio. Violations of the securities laws are compensable regardless of whether there was an increase or decrease in the value of the portfolio. *Miley v. Oppenheimer & Company, Inc.,* 637 F.2d 318, 326 (5thCir. 1981). Each transaction stands on its own and profits from other trades are not relevant to damages calculations. *Kane v. Shearson Lehman Hutton, Inc.,* 916 F.2d. 643, 646 (11th Cir. 1990); *Merchant*, 568 F.Supp. at 644. A court of appeals opinion from New Mexico interpreting the portion of their securities anti-fraud statue that is the equivalent to A.R.S. § 44-1991(A)(2) and worded very similarly, found that plaintiff was entitled to seek damages for any violation of their securities anti-fraud statute regardless of profits made on other sales. *Treider v. Doherty and Company,* 527 P.2d 498, 501 (N.M.App. 1974). Losses and gains should not be netted to benefit the violator of the securities laws. *Kane,* 916 F.2d at 646; *Levine v. Futransky,* 636 F.Supp. 899, 900, (N.D.Ill. 1986).

1. Restitution Owed to Ms. DuChene

Respondent attempts to mask his fraudulent actions and the resulting losses including sales charges, with performance analysis and tables showing net profits in securities accounts. He gives no recognition to the fact that during much of the time he was the financial adviser for Ms. Duchene there was a roaring bull market. To allow Respondent to exonerate his misdeeds only because Ms. DuChene's portfolio as a whole was profitable would be inexcusable.

The Division showed at the hearing, through Mr. Donovan, how Ms. DuChene lost a total of $30,107.27 in unsuitable losses and charges. *Exh. S-5.* This amount is a fair and equitable restitution amount for Ms. DuChene.

Respondent, at the hearing, showed withdrawals and additions to Ms. DuChene's accounts. *Exh. R-2A.* Respondent should not be given credit for at least some of the withdrawals from Ms. DuChene's account because the source of the income or appreciation was from suitable investments not from unsuitable investments such as the High Income/Yield fund. *Exh. R-2A,* pages 1088 and 1089.

Respondent constructed a table showing that Ms. DuChene received $19,768.93 in income dividends from the High Income/Yield fund. *Exh. R-2A,* pages 1097-1100. The intent of this table as with the others, was to offset the losses the Division was alleging with income from the High Income/Yield fund. Ms. DuChene should not now be punished financially for receiving what she wanted which was income.

If the Commission does decide to offset losses incurred by unsuitable activity in Ms. DuChene's accounts by Respondent, then it should also impose interest on each unsuitable investment from the date it was purchased until the date it was exchanged, sold or transferred away from Respondent pursuant to A.R.S. § 44-1201 (currently ten-percent). This is the approach taken in Rule R14-4-308(C). *A.A.C. R14-4-308(C)(1)(b).* This is an administrative rule the Commission can utilize to require someone who has violated the Securities Act to pay restitution.

2. Restitution Owed to Ms. Brotherson.

The Division showed at the hearing through use of an exhibit and expert testimony from Mr. Donovan how Ms. Brotherson should receive restitution of $43,625.43, due to Respondent's fraudulent activities in her account. *Exh. S-21.* This is a fair representation of what Ms. Brotherson lost in unsuitable transactions and charges in her account. Respondent made the same arguments at the hearing contending the income from the High Income/Yield fund should offset any losses incurred in her account. Respondent did not admit into evidence any table summarizing the income she received from this fund or any other fund she held while Respondent was her financial adviser.

The Division asserts just as in the argument above regarding Ms. DuChene, that offsetting losses in her account with income from securities in her portfolio would be inequitable to her. Ms. Brotherson owned preferred stock in one company (shown on account statements as "DEVEL DIV RLTY 9.44% B SH PRF") that provided income to her for most of the time Respondent was her financial adviser. This investment was deemed by the Division's expert Mr. Donovan to be suitable since it was not listed as an unsuitable investment in the review and analysis table he

created. *Exh. S-21.* Income from this suitable investment should not benefit Respondent by offsetting it against losses in Ms. Brotherson's account.

If the Commission does offset losses in Ms. Brotherson's account with income from her portfolio, then as argued above, the Commission should impose ten-percent interest on each unsuitable investment from the date of purchase to the date it was exchanged or sold.

3. Restitution Owed to Ms. Hays.

As mentioned above, the only unauthorized transaction Ms. Hays complained about was the exchange of shares in the Dividend Growth fund for shares in the Information fund in September 2000. *Exh. S-47,* ACC04248. The value of the Information fund on the date of exchange was $10, 115. *Exh. S-47,* ACC04248. In October 2001, Ms. Hay's shares in the Information fund were exchanged for shares in the Health Sciences fund, a fund she had owned a minimal value in since at least June 2000. *Exh. S-47,* ACC04268. This was done with her approval. *H.T.,* page 1482, lines 2-10. The value of this exchange was $3,312. *Exh. S-47,* ACC04268; *H.T.,* page 1482, lines 12-14. The difference between $10,115, the value of the unauthorized exchange in September 2000 and $3,312, the value of the exchange in October 2001, is $6,803, the amount of loss resulting from the unauthorized exchange perpetrated by Respondent.

IV.

RELIEF REQUESTED

In light of the foregoing, the Division requests that the Commission grant the following relief against Respondent Philip William Merrill.

A. Cease and Desist Order.

Pursuant to A.R.S. § 44-2032, Respondent should be ordered to permanently cease and desist from violating A.R.S. § 44-1991(A) of the Securities Act.

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B. Order of Restitution.

Pursuant to A.R.S. § 44-2032(1), Respondent should be ordered to pay total restitution of $80,535.70 as follows: the amount of $30,107.27 to Beatrice DuChene; the amount of $43,625.43 to Viola Brotherson; and the amount of $6,803 to Sylvia Hays.

C. Administrative Penalties.

Pursuant to A. R. S. § 44-2036(A), Respondent should be assessed administrative penalties in an amount not to exceed five thousand dollars for each violation of the Securities Act. By reviewing the record in this matter it is clear that Respondent violated A.R.S. § 44-1991(A) by recommending unsuitable transactions to two of his customers and conducting unauthorized transactions in the accounts of five of his customers. Respondent admitted to conducting at least four unauthorized trades in the accounts of Lori Mayfield. Based upon Respondent's violations of the Arizona securities anti-fraud statute proven at the hearing, Respondent is subject to cumulative penalties for multiple violations. The Division believes that Respondent should be ordered to pay not less than $30,000 in administrative penalties based on his conduct.

D. Revocation or Suspension of Respondent's Arizona Securities Registration.

Pursuant to A.R.S. § 44-1962(A), Respondent's registration as a securities salesman in Arizona should be revoked. Respondent violated the trust and confidence of his customers. Respondent caused monetary damages to his customers as a result of his fraudulent activities in their securities accounts.

One of the fraudulent activities Respondent engaged in was conducting unauthorized transactions in his customers' accounts. Respondent, by his own admissions, engaged in unauthorized transactions in the accounts of Lori Mayfield (unauthorized transactions: December 2000 and January 2001), even after he wrote a letter to the NASD addressing allegations by Ms. DuChene that he had conducted unauthorized transactions in her accounts. *Exh. 50*, pages ACC01661, ACC01840, ACC02829, ACC02832. The letter is dated June 2, 2000, and reads in part , "I . . . will endeavor to prevent even an appearance of the type of conduct mentioned in your

letter. Specifically, I will consult with my Supervisors at any point when I become aware of a situation that could arise leading to the kind of allegations raised by Ms. DuChene." *Exh.* 50, page ACC01661. He also wrote in the same letter that he had reviewed various rules and regulations of the NASD, the NYSE and Morgan Stanley's compliance manual with respect to provisions such as know your customer rule, discretionary trading and suitability. *Exh.* 50, page ACC01661. Yet, Respondent after all this, conducted unauthorized trades in Lori Mayfield's accounts approximately six months later and continued to conduct unsuitable trades in his customers' accounts.

The Division has shown through the course of the case how Respondent violated the Securities Act, particularly A.R.S. § 44-1991(A), is lacking in integrity and is not of good business reputation and has engaged in dishonest and unethical practices in the securities industry pursuant to A.A.C. R14-4-130(A)(4) and (6). These securities law violations provide ample reason to revoke Respondent's securities registration in Arizona.

E. Other Relief.

The Division requests any other relief the Commission in its discretion deems appropriate and authorized by law.

Respectfully submitted this 14th day of April, 2003.

Terry Goddard
Attorney General for the State of Arizona

Anthony B. Bingham
Special Assistant Attorney General
Moira McCarthy
Assistant Attorney General
Attorneys for the Securities Division of the
Arizona Corporation Commission

Original and thirteen copies
of the foregoing hand-delivered
this 11th day of April, 2003, to:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007

A copy of the foregoing mailed
this 11th day of April, 2003, to:

Frank Lewis
Begam Lewis Marks & Wolfe
111 West Monroe Street, Suite 1400
Phoenix, AZ 85003-1787

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BEATRICE DUCHENE

EXPOSURE TO MSDW HIGH INCOME/YIELD BOND FUND

1997	29773	35355	SUM	HYB FUND	%	
JANUARY						
FEBRUARY	232,019	25,184	257,203	56,460	21.95%	
MARCH	218,952	23,797	242,749	55,553	22.88%	
APRIL	224,518	25,121	249,639	55,156	22.09%	
MAY						
JUNE	241,455	27,788	269,243	83,186	30.90%	
JULY	253,832	30,914	284,746	84,101	29.54%	
AUGUST	246,582	29,322	275,904	83,852	30.39%	
SEPTEMBER	255,406	31,375	286,781	84,850	30%	
OCTOBER	249,139	29,973	279,112	83,852	30%	
NOVEMBER	252,652	31,129	283,781	82,374	29%	
DECEMBER	249,728	30,794	280,522	82,253	29.32%	
					276.07/10 =	**27.61%**

1998	29773	35355	46102	SUM	HYB FUND	%
JANUARY						
FEBRUARY	257,017	33,156		290,173	82,253	28.34%
MARCH	270,506	35,492		305,998	89,001	29.08%
APRIL						
MAY						
JUNE	259,268	35,852		295,120	87,032	29.49%
JULY						
AUGUST						
SEPTEMBER	193,030	33,595		226,625	79,025	34.87%
OCTOBER	1,500	32,983	197,387	231,870	76,530	33.00%
NOVEMBER	Ø	35,486	202,505	237,991	75,626	31.77%
DECEMBER						
						186.55/6=31.09%

EXHIBIT A

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